

# FERC UPDATE ON ANTI-MARKET MANIPULATION – POWER

U.S. Federal Energy Regulatory Commission and U.S. Commodity Futures Trading Commission

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# ACKNOWLEDGING THE ELEPHANT IN THE ROOM: CHANGING ADMINISTRATIONS

- Both the CFTC and FERC are “Independent Agencies”
  - President nominates and Senate approves the Commissioners; President names the Chairperson
  - 5 slots: 3 from President’s party; 2 from other
- Current CFTC Commissioners (2 Democrats, 1 Republican)
  - Chairman Timothy G. Massad (D)
  - Commissioner Sharon Y. Bowen (D)
  - Commissioner J. Christopher Ciancarlo (R)
- FERC Commissioners (3 Democrats)
  - Chairman Norman C. Bay (D)
  - Commissioner Cheryl A. LaFleur (D)
  - Commissioner Colette D. Honorable (D)



# THE REGULATORY LANDSCAPE

## FERC Annual Enforcement Report (FY 2016)

- Statistics
  - 6 settlements (with 11 subjects)
  - 17 new investigations
  - 11 pending investigations closed without further action
  - > 40 Division of Analytics investigations
  - 110 new self-reports
  - 126 self-reports closed (most ISO/RTO-related)
- Manipulation White Paper
- Compliance White Paper
  - Still “no one-size-fits-all approach,” but FERC staff identifies core elements and examples of effective practices
  - Substantial focus on market manipulation

## CFTC Annual Enforcement Report (FY 2016)

- Statistics
  - 68 enforcement actions
  - 4 manipulation, false reporting, disruptive trading
  - 4 Misappropriation of non-public information (insider trading)
  - 4 other trade practices
  - \$1.29 billion in restitution, disgorgement, and penalties
  - \$10 million whistleblower award
- “High impact” cases
  - Insider Trading (two cases brought against employees)
  - Spoofing and manipulation (Igor Oystacher)
  - Citibank LIBOR and ISDAfix cases (manipulation)
  - Fictitious and noncompetitive block trades
  - Total natural gas settlement

# THE REGULATORY LANDSCAPE (CONT'D)

## Federal Energy Regulatory Commission (FERC)

- Public Cases (Power)
  - Barclays, et al. (U.S. Dist. E.D. Cal.)
  - Competitive Energy Services, et al. (U.S. Dist. Maine)
  - Powhatan, et al. (U.S. Dist. E.D. Va.)
  - City Power, et al. (U.S. Dist. D.C.)
  - Coaltrain et al. (U.S. Dist. S.D. Ohio)
  - ETRACOM, et al. (U.S. Dist. E.D. Cal.)
- 2016 Settlements (Power)
  - Maxim (Manipulation)
  - Lincoln Paper and Tissue (Manipulation)
  - National Energy & Trade and David Silva (Manipulation)
  - Berkshire Power Co. (Fraud)
  - Saracen Energy Midwest (Tariff Violations)

## Related Developments

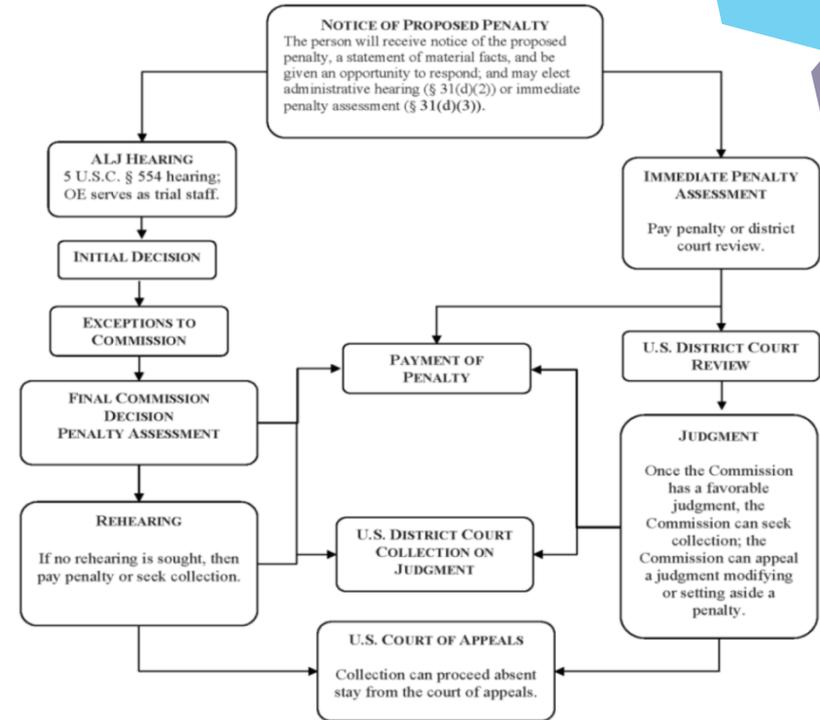
- FERC Gas
  - BP America, Inc. (Final Order; 5th Cir. Appeal)
  - Total Gas & Power NA, et al. (Show Cause; 5th Cir. Petition)
- Commodity Futures Trading Commission (CFTC)
  - CFTC vs Total (Energy)
  - CFTC vs Kraft Foods (End-User)
- Exchange Investigations
  - Prearranged trading
  - Disruptive trade practices
- Criminal and Civil Actions
  - Spoofing: U.S. vs Coscia, U.S. vs Sarao, U.S. v. Oystacher
  - Barclays Class Action

## PRIVATE RIGHTS OF ACTION

- October 18, 2016 Final Order to Exempt Certain Specified Transactions of Southwest Power Pool and Amendment to the 2013 Final Order Regarding RTOs and ISOs
  - Expressly exempts conduct in RTOs/ISOs from private rights of action
  - Only addresses liability pursuant to the Commodity Exchange Act
  - Does not apply to activity outside of RTO/ISO markets
  - Preserves CFTC authority to pursue fraud and manipulation within RTO/ISO markets

# FEDERAL POWER ACT “*DE NOVO* REVIEW”

- The FPA sets out two procedural avenues for respondents in actions where FERC has proposed to assess a civil penalty (16 U.S.C. § 823b(d)):
- **Administrative Law Judge (“ALJ”) hearing:** A respondent may elect to adjudicate the allegations before a FERC ALJ, including a full trial and discovery rights. FPA Section 31(d)(2).
- **Immediate penalty assessment and “*de novo*” review:** Alternatively, a respondent may elect an immediate penalty assessment, followed by “*de novo* review” of any FERC order assessing civil penalties against the respondent in a U.S. District Court. FPA Section 31(d)(3)(A).
- Scope of “*de novo* review,” i.e., trial *de novo* or some variation thereof, is being tested in the courts.
- Trending towards a process that involves more than mere consideration of the administrative record as presented by FERC.
- Discovery Rights
- This is also being tested in the courts, with a general trend towards some type of supplementary discovery rights being afforded to respondents.



Source: FERC Policy Statement Regarding Process for Assessing Civil Penalties



# WHAT IS MARKET MANIPULATION?

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# ANTI-MANIPULATION RULES

- Under FERC and CFTC anti-fraud rules, it generally is unlawful to:
  - use or employ any device or scheme, or artifice to defraud;
  - make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading; or
  - engage in any act, practice, or course of business that operates or would operate as a fraud or deceit upon any entity
- FERC defines “fraud” to include “any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market”
- The CFTC also has legacy manipulation authority under which it must prove:
  - the defendant had the ability to establish an artificial price
  - it acted with the specific intent to do so
  - an artificial price actually existed, and
  - the defendant caused the artificial price

# CFTC DISRUPTIVE TRADING PRACTICES

- CFTC also prohibits “disruptive trading practices”
  - Violating bids and offers
    - Strict liability
    - No best execution standard
  - Intentional or reckless **disregard for the orderly execution of transactions** during the closing period
    - Closing period generally means period when daily settlement price is determined
    - Treat price setting periods as “No Wake Zones”
  - Spoofing (a.k.a., “bluffing”)
    - Bidding or offering with the intent to cancel the bid or offer before execution
    - No manipulative intent required

# WHITE PAPER ON ANTI-MARKET MANIPULATION ENFORCEMENT EFFORTS (NOV. 17, 2016)

- Key elements of market manipulation (identified by FERC staff):
  - “Fraud is a question of fact and is defined generally ‘to include any action, transaction, or conspiracy for the purpose of impairing, obstructing or defeating a well-functioning market’”
  - Open-market transactions can be fraudulent (based on intent)
  - Fraud is a catch-all that does not require any explicit rule violation
  - Artificial price is not required
  - No harm is required
  - Scierter can be “established by legitimate inferences from circumstantial evidence,” and a manipulative purpose will satisfy scierter even if combined with a legitimate purpose
  - “In connection with” jurisdictional markets includes activity in or directly affecting jurisdictional markets
  - Individuals are “entities” subject to the prohibition
- “Gaming” – “taking unfair advantage of the rules and procedures ... to the detriment of the efficiency of, and or consumers in, the [markets]”

# CROSS-MARKET / CROSS-PRODUCT MANIPULATION

- Barclays, et al.
  - Assembled large physical index positions in the opposite direction of its swap exposure
  - Flattened physical index positions in the next-day fixed-price physical markets
  - “Barclays’ trading of next-day fixed-price physical against index produced substantial, repeated, and avoidable losses in its next-day fixed-price physical trading to move the settlement of daily indices in the direction that benefited its financial swaps”
  - Note: Class Action
- ETRACOM, et al.
  - Allegedly submitted uneconomic virtual supply offers after export congestion at intertie reduced profitability of congestion revenue rights (CRR) position
  - Virtual supply offers countered export congestion and lowered day-ahead prices, profiting the CRR position

# CROSS-MARKET / CROSS-PRODUCT MANIPULATION (CONT'D)

- National Energy & Trade and David Silva
  - Accused of manipulating “physical natural gas prices between January 1, 2011 and September 30, 2015 at the Houston Ship Channel, Tetco M3, Transco Zone 6 (New York), and Henry Hub in order to benefit its related financial positions”
  - Examples of evidence of manipulation include:
    - Benefiting Positions (e.g., “sold financial basis at Tetco M3 during the week before”)
    - Framing the Open (“trader began offering to sell physical basis at 2:17 a.m., almost three hours before any other market participant submitted a bid or offer”)
    - Aggressive Offers (“physical basis opening offer was approximately 10 cents below the most recent prices of consummated physical basis and financial basis offers from twelve hours before” ... “initiated the twenty lowest offers out of the forty-one physical basis offers made)
    - Market Share (“63 percent of all sales that day”)
    - Liquidation of Related Position (“consummated all twenty-five of its physical basis sales before beginning to repurchase the financial basis position it sold the week before”)

# GAMING / INTERFERING WITH A WELL-FUNCTION MARKET

- Up to Congestion Cases (Powhatan Energy, City Power, and Coaltrain)
  - Traded up to congestion (UTC) using low-risk spread and “wash-like” trades designed to collect Marginal Loss Surplus Allocations (MLSA) credits in PJM
  - “Respondents’ fraudulent trades were undertaken with MLSA as the sole or primary price signal, not price spread arbitrage which could result in a benefit to the market” (Coaltrain)
  - “FERC’s present view of virtual UTC trading, moreover, is consistent with what it said in the 2008 Black Oak orders [where] FERC described UTCs as ‘arbitrage transactions’ and the virtual traders engaged in them as ‘arbitrageurs’ ... [and] expressed clear disapproval of the possibility that virtual traders might seek to profit by simply maximizing MLSA instead of reacting to price differences” (City Power)
- Compare Saracen Energy Midwest (Tariff Violations) – submitted offers in four separate auctions for transmission congestion rights (“TCR”) at Electronically Equivalent Settlement Locations (“EESL”), violating tariff prohibition without intent

## GAMING / INTERFERING WITH A WELL-FUNCTION MARKET (CONT'D)

- Competitive Energy Services, et al.
  - Allegedly advised industrial load response participants to curtail on-site generation during Day-Ahead Load Response Program (DALRP) hours in ISO-NE
  - “The practice “artificially inflated the participant’s baseline load and misrepresented the participant’s load profile to ISO-NE”
- Aiding and abetting liability?
  - The court “agree[d] that a party that only aided and abetted the manipulations of another is not subject to liability”
  - But, “According to FERC, ‘CES (including Silkman and other employees) . . . communicated daily to ISO-NE Rumford’s availability to provide approximately 20 MW of electricity ‘reduction.’”

# MISREPRESENTATIONS

- Maxim Settlement (\$ 4 million penalty; \$ 4 million disgorgement)
- Allegations: fraudulent scheme through misrepresentations and material omissions
  - Offered generation in ISO-NE based on (expensive) fuel oil
  - Called upon to run for reliability (out-of-merit)
  - Burned (cheaper) natural gas
  - Told Market Monitor “offering conservatively” based on pipeline restrictions
  - Paid on fuel oil but ultimately mitigated
- Resolves additional claim of market manipulation against Maxim
  - Inflated make-whole payments by rolling Startup into variable component of energy offer
  - Circumvented tariff provision that limited make-whole payments over course of 4 hour minimum run time for unit to 110% of “all-in” offer price (i.e., Startup, No Load, and Energy charges)
  - Effectively permitted Maxim to receive an additional Startup payment for every four hours of operation

## INFLUENCING PRICE OR CREATING ARTIFICIAL PRICE?

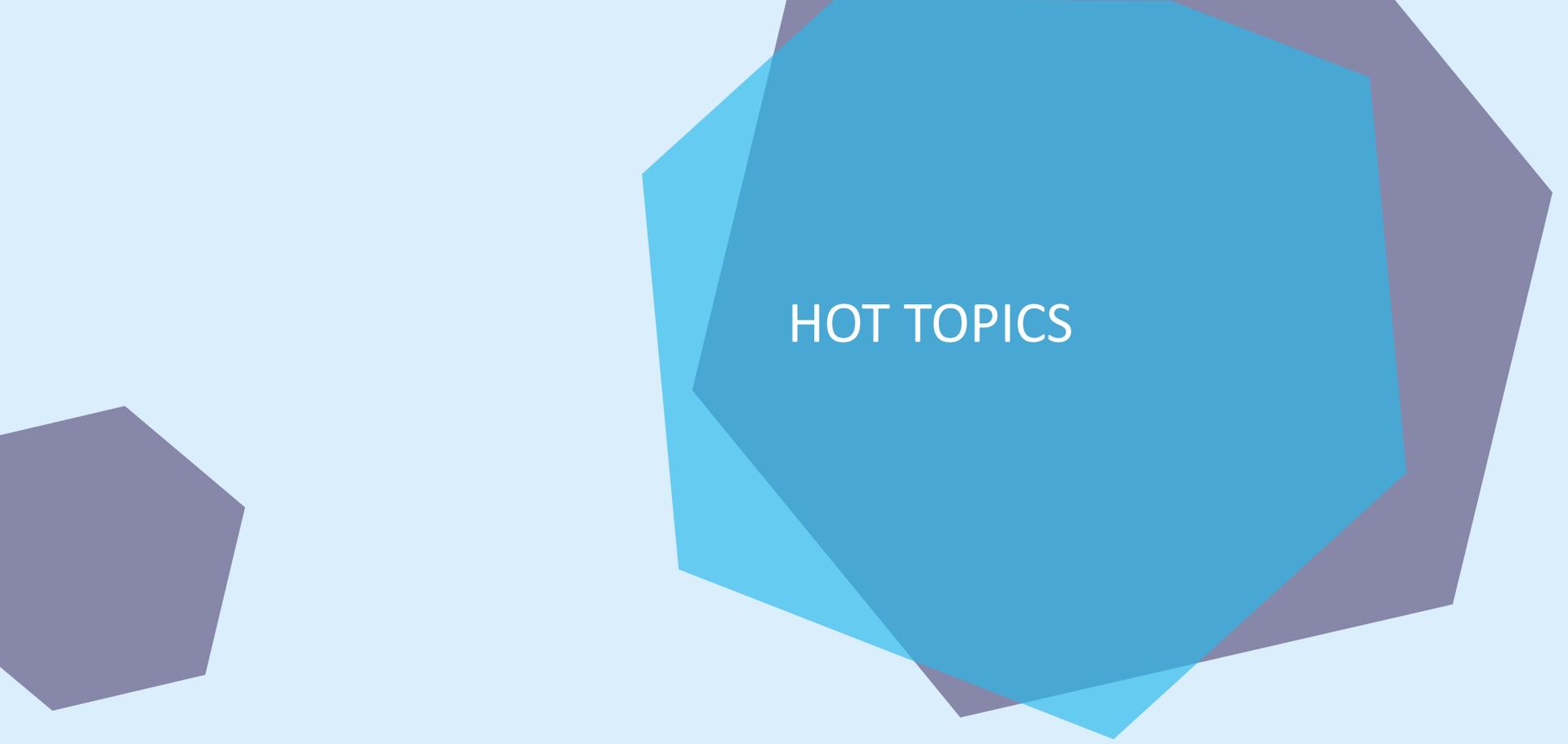
- Total Show Cause Order and Notice of Proposed Penalty (Apr. 28, 2016)
  - Cross Market Manipulation – allegedly traded fixed-price natural gas during bid-week to benefit a related position at four locations in southwestern United States
  - Proposed civil penalty for Total: \$213.6M
  - Proposed individual penalties: \$1M and \$2M (jointly and severally with Total)
  - Disgorgement against Total: \$9.18M, plus interest
- CFTC Settlement (Dec. 7, 2015)
  - Total and one individual jointly and severally liable for \$3.6M in civil penalties
  - Trading limitations during bid-week for Total and individual and quarterly reporting obligation

Note: CFTC Whistleblower Incentive Program

Note: FERC disregarding corporate form

## INFLUENCING PRICE OR CREATING ARTIFICIAL PRICE? (CONT'D)

- What if intent is to set index at an accurate price (not artificial)?
- Consider CFTC vs DRW Holdings LLC / Don Wilson
  - Convexity Bias - “The swaps market has not fully absorbed the implications of this pricing problem”
  - Allegation: “Wilson and DRW developed and implemented a manipulative strategy designed to affect or influence the daily settlement rates of the Three-Month Contract after Wilson and DRW had established a significant long open futures position in the Three Month Contract through the bilateral”
  - National Futures Association separately concluded: “It appears the orders were entered in a manner consistent with DRW’s claims” and that the exposure the orders had to the market “appears to mitigate the probability of the firm utilizing manipulative order strategies”



HOT TOPICS

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# SPOOFING (A.K.A., BLUFFING)

- ICE Rule 4.02 and NYMEX Rule 575
- It's not just high frequency traders ... (see Kurlansik, NYMEX 14-9952-BC)
  - “[Trader] entered large manual orders in Heating Oil futures contracts without the intent to trade ... To encourage market participants to trade opposite his smaller orders that were resting on the opposite side”
  - Settlement - \$35,000 penalty and 10-day suspension, plus publication
- Individual liability ... (see Coscia conviction and Oystacher action)
  - Michael Coscia convicted of manipulation and spoofing
    - “COSCIA devised this strategy to create a false impression regarding the number of contracts available in the market, and to fraudulently induce other market participants to react to the deceptive market information”
    - Faces additional penalties and prison (already paid ~\$4.4M)
  - Civil action pending against Igor B. Oystacher and his company, 3 Red Trading LLC, for alleged spoofing scheme involving five futures products across four exchanges (settlement in principle reportedly reached)

# INSIDER TRADING

- Insider Trading
  - The CFTC has an express insider trading prohibition that proscribes the use of non-public information obtained by or from government or exchange officials
  - In addition, the CFTC has said “trading on the basis of material nonpublic information in breach of a pre-existing duty (established by another law or rule, or agreement, understanding, or some other source), by trading on the basis of material nonpublic information that was obtained through fraud or deception, may be in violation of [the CFTC’s anti-manipulation rule].”
- CFTC vs Motazedì
  - “Motazedì and his employer shared a relationship of trust and confidence that gave rise to a duty of confidentiality. In addition, his employer's internal policies prohibited the misuse of proprietary or confidential information, and prohibited employees from engaging in personal transactions involving energy contracts and other personal transactions that created an actual or potential conflict of interest ... Motazedì breached his duties to his employer by using this information to trade in personal trading accounts and by failing to disclose such trading to his employer”
  - Permanent ban, \$100,000 penalty, and \$216,955.80 restitution (plus interest)



# FERC STAFF EXPECTATIONS

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# COMPLIANCE WHITE PAPER (NOV. 17, 2016)

- Designing the Program:
  - Hire compliance personnel with a variety of experience (e.g., legal, operations, risk management, trading)
  - Integrate compliance personnel into the organization's business units and empower
  - Provide adequate resources, including staffing, compensation, compliance-related technology resources, and regular audits
  - Encourage networking with other compliance professionals
  - Human Resources – background checks and tying compensation to compliance
- Training
  - Tailor training to specific trading activities; vary training styles (group, one-on-one, newsletters, Q&A sessions, reference manuals, and computer-based training with quizzes); topic-specific trainings; disseminate information in timely manner
  - Track participation (whether voluntary or mandatory)
- Perform regular audits of compliance program
  - Document audits and address all issues identified
  - Potential schedule: full audit every two years or audit one element every six months

# COMPLIANCE WHITE PAPER: DETERRING AND DETECTING MARKET MANIPULATION

- Trading rules and restrictions:
  - Maintain list of prohibited trading strategies and require approval for new products/locations
  - Document trading strategies
  - Restrict/discourage use of price-setting instruments to benefit related positions
    - Document trading strategies related to physical and financial positions
    - Establish loss limits in price-setting instruments
    - Position limits for financial products
    - Establish concentration levels that trigger compliance reviews
- Enforcement
  - Follow-up and document all potential non-compliance
  - Establish and enforce consequences for noncompliance

# COMPLIANCE WHITE PAPER: DETERRING AND DETECTING MARKET MANIPULATION (CONT'D)

- Monitoring:
  - Statistical reviews of position concentrations
  - Review activities at locations where engaged in physical and financial trading
  - Review activities at locations where engaged in both virtual and other financial trading
  - Track P&L for product and location combinations
  - Monitor for changes in the amount and types of make-whole or out-of-market payments received from RTO/ISO activities
  - Periodically review generating unit cost-based offers submitted to an RTO/ISO to ensure consistent with market rules
  - Post hoc analysis of natural gas pipeline nominations and flows during periods of pipeline constraint
  - Record/retain trading communications for at least 5 years (require using company services only and record all emails, IMs, and calls)
  - Regularly review communications
  - Encourage discussion and reporting of compliance concerns (no retribution)
  - Provide anonymous reporting opportunities

# COMPLIANCE WHITE PAPER: INEFFECTIVE PRACTICES

- The following practices identified as ineffective:
  - Overreliance on long, standardized annual trainings
  - Failing to involve commercial/operational staff in training
  - Insufficient funding
  - Allowing commercial trading staff to overrule compliance
  - Overreliance on off-the-shelf compliance tools without customization
  - Failing to regularly assess and update compliance practices
  - Failing to monitor for violations or discipline in a meaningful way
  - Implementing policies that inhibit or prohibit the retention of trader communications

## WHAT DOES IT ALL MEAN?

- Questions to answer:
  - Documenting?
  - Investment in monitoring?
- Hot topics to cover:
  - Manipulation
  - Disruptive trade practices
  - Insider trading
  - Exchange rules
- Other things to consider:
  - Individual liability
  - Whistleblower protection/awards
  - Corporate form

THANK YOU!



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